

**BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF CALIFORNIA**

In the Matter of the Rate Application of)	
)	
AMERICAN HEALTHCARE INDEMNITY)	File No.: PA-02025379
COMPANY and SCPIE INDEMNITY)	
COMPANY,)	
)	
Applicants.)	
_____)	

The proposed decision of Administrative Law Judge Marjorie A. Rasmussen dated July 24, 2003 was adopted as the Insurance Commissioner's decision in the above-entitled matter.

This order was effective September 22, 2003.

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PROPOSED DECISION

I. INTRODUCTION

A. Background

American Healthcare Indemnity Company and SCPIE Indemnity Company (hereinafter referred to as “SCPIE”) seek a rate increase of 15.6% for its physicians and surgeons medical malpractice program.

SCPIE is a mono-line California insurance company that offers professional liability coverage for physicians and surgeons principally in Southern California with minor programs in a few other states. SCPIE’s predecessor company was formed as a reciprocal insurer during the California medical malpractice crisis of the mid-1970’s to provide medical malpractice coverage

for its member physicians.¹ SCPIE is one of four mono-line medical malpractice insurance companies in California. The company reorganized in 1997 as a stock insurance company and is wholly-owned by SCPIE Holdings, Inc., a corporation publicly traded on the New York Stock Exchange.²

The Foundation for Taxpayer and Consumer Rights (hereinafter referred to as the “Foundation”) is a nonprofit, nonpartisan public interest corporation organized to represent the interests of insurance consumers (particularly in Proposition 103 rate rollback and prior approval rate cases). The Foundation requested a hearing on SCPIE’s proposed rate change and contends in this proceeding that SCPIE has not met its burden of showing that the proposed rate increase (or any rate increase) is not excessive under Insurance Code §1861.05.³

The California Department of Insurance (hereafter referred to as the “CDI”), while appearing as a party in this matter, did not submit evidence for or against the requested rate increase and did not take an active role in the evidentiary hearing.

In support of its rate request, SCPIE submitted the testimony of its Vice President and Associate Actuary, Mr. James Robertson, who oversaw the rate filing. SCPIE also submitted the testimony of Mr. James Hurley, a consulting actuary with Tillinghast-Towers Perrin, (“Tillinghast”) who was responsible for issuing Tillinghast’s rate study of SCPIE’s loss and

¹ SCPIE Post Hearing Brief, p. 3; Mr. Robertson’s written testimony dated April 30, 2003, p. 4. Henceforth, all written testimony whether submitted as pre-filed direct, additional direct, supplemental direct, rebuttal or written testimony in response to questions posed by the ALJ will be cited as “WT”, followed by the name of the witness, the date the witness signed the testimony and the page number. Opening and initial post-hearing briefs will be cited as “OB” and will be preceded by the name of the party and followed by the page number. Reply briefs will be cited as “RB” and will be preceded by the name of the party and followed by the page number. Citations to exhibits will be cited as “Exhibit” and will be preceded by the name of the party sponsoring the exhibit and followed by the Bates stamp number. The reporter’s transcript of the evidentiary hearing will be cited as “RT” followed by the volume and page number.

² SCPIE OB, p. 3; WT Mr. Robertson, April 30, 2003, pp. 3-4.

³ Foundation OB, pp. 5-8.

expense experience entitled “2003 Rate Indications Based on Data Evaluated as of 3/13/02” (“2003 Rate Study”) and who prepared, subject to the review and adoption of SCPIE, the exhibits to the rate application. In addition, SCPIE submitted the testimony of Mrs. Irene Bass, a consulting actuary with Bass & Khury. Mrs. Bass offered an expert opinion on the actuarial soundness of SCPIE’s proposed rate change and prepared various calculations of the indicated rate change using elements of the regulatory formula for determining the maximum permitted earned premium set forth in California Code of Regulations, title 10, §2644.2 *et seq.* (hereinafter referred to as “regulatory formula”).⁴ SCPIE also submitted the testimony of Dr. David Appel, Ph.D., Director of Economics Consulting and a principal in the firm of Milliman, U.S.A, Inc. Dr. Appel offered an expert opinion on the economic and financial issues underlying SCPIE’s proposed rate change. The Foundation submitted the testimony of its retained expert, Mr. Allen Schwartz, President of AIS Risk Consultants, an actuarial consulting firm. Mr. Schwartz offered an expert opinion on whether SCPIE’s proposed rate change was excessive pursuant to the regulatory formula.

B. Procedural History

SCPIE filed its rate applications nos. 02-33562 and 02-33563 with the CDI on September 13, 2002.⁵ The rate applications, which sought an increase of 15.6%, were subsequently approved by the CDI on November 12, 2002.⁶ On November 22, 2003, the CDI rescinded its approval of SCPIE’s rate request because the Foundation filed a timely petition for hearing.⁷ Insurance Code §1861.05(c) states the Commissioner must hold a hearing upon a timely request

⁴ Henceforth, all citations to Regulation sections will be to California Code of Regulations, title 10, unless otherwise indicated, and designated as CCR §xxx.

⁵ SCPIE Exhibit 1, p. 0001-0174.

⁶ SCPIE Exhibit 2, p. 0175.

⁷ SCPIE Exhibit 3, p. 0176.

when the proposed commercial lines rate adjustment exceeds 15% of the then applicable rate. On December 11, 2002, SCPIE timely filed its Notice of Defense.⁸ A scheduling conference was held before Administrative Law Judge Marjorie A. Rasmussen (hereinafter referred to as “ALJ”) on January 2, 2003, in Los Angeles, California. On January 9, 2003, the ALJ issued an amended Scheduling Conference Order setting dates for: (a) completing discovery and designating witnesses in January and February 2003; (b) filing written testimony, exhibits and pre-hearing motions in January, February and March 2003; and (c) the commencement of the evidentiary hearing on March 11, 2003, in Los Angeles, California.

SCPIE and the Foundation lodged their respective pre-filed direct testimony and then timely filed motions to strike. Following briefing and a hearing, the Foundation’s motion to strike portions of the direct testimony of Mrs. Bass, Mr. Robertson and SCPIE Exhibits 2 and 3 was denied on February 25, 2003. On March 7, 2003, SCPIE’s motion to strike portions of Mr. Schwartz’s testimony and Foundation Exhibits 111 and 112 was granted in part and denied in part. SCPIE’s motion to strike was granted with respect to Mr. Schwartz’s interpretation of the laws and regulations governing these proceedings and his opinions on whether SCPIE is in conformity with these laws. SCPIE’s motion to strike Mr. Schwartz’s economic opinions and their basis along with the Foundation’s Exhibits 111 and 112 was denied, subject to later renewal after expert *voir dire*.⁹ Based in part on the relitigation ban in CCR §246.4(e), the ALJ also denied SCPIE’s accompanying request for judicial (official) notice of the unpublished decision

⁸ The Administrative Hearing File reflects that on November 27, 2002, SCPIE filed with the CDI a Withdrawal Notice of SCPIE’s Rate Applications and a Request to Vacate Order Granting Petition for Hearing. Subsequently, on December 10, 2002, before any action had been taken on the request to vacate, SCPIE notified the CDI that it wished to proceed with the hearing requested by the Foundation and withdrew its earlier requests to vacate the order granting the petition for hearing and to rescind SCPIE’s rate applications.

⁹ SCPIE did not renew its objection to Mr. Schwartz’s testimony or to the exhibits at the hearing.

of *Dawson v. Allstate Insurance Company* (case no. A086143 filed September 13, 2000) and the declaration by Paul Alexander as evidence of the legislature's intent on how the regulations implementing the provisions of Proposition 103 should be applied in prior approval hearings.

As ordered, the evidentiary hearing commenced on March 11, 2003, and was completed on March 13, 2003. Additional written testimony was submitted in rebuttal and in response to questions posed by the ALJ. The parties submitted opening and reply briefs and filed an updated Joint Exhibit List on June 20, 2003. Following receipt of the parties' briefs, the date tentatively set for oral argument was cancelled. The record was closed and the case submitted on June 24, 2003.

II. LEGAL STANDARD FOR APPROVAL OF PROPOSED RATES

A. Parties' Contentions

SCPIE contends that the burden of proof should fall on the Foundation because it is challenging the reasonableness of a rate the CDI initially approved and, in a rate hearing, the burden of proof should be placed on the party presenting the affirmative case. SCPIE also contends that the ALJ should not test SCPIE's proposed rate increase by using the regulatory formula because it is incomplete. SCPIE points out that none of the commissioners has adopted the generic determinations¹⁰ contained in the regulatory formula since Proposition 103 was passed. As a consequence, SCPIE argues, the ALJ may use the regulatory formula as a guide, altering its components when they do not make sense and inserting reasonable actuarial values for the generic determinations.

¹⁰ SCPIE OB, pp. 7-12.

The Foundation and the CDI counter SCPIE's burden of proof arguments by contending that Insurance Code §1861.05(b) places the burden of proof for a requested rate change on the applicant and SCPIE waived its right to challenge the assignment of the burden of proof in this case. The Foundation further contends that, by law, the ALJ must apply the regulatory formula to SCPIE's data in support of its rate application in determining whether SCPIE's proposed rates are excessive.¹¹

SCPIE initially raised its scope of review arguments in its motion to strike portions of Mr. Schwartz's pre-filed direct testimony and in SCPIE's request for judicial notice. By order dated March 10, 2003, the ALJ ruled that SCPIE's rates would be reviewed by the regulatory formula. SCPIE reiterates its scope of review arguments in its post hearing brief and, in addition, now disputes that it bears the burden of proof in this matter. As explained below, the laws governing the scope of review and the burden of proof in prior approval rate hearings are not ambiguous and SCPIE's arguments to the contrary are without merit. Likewise, the Foundation's argument in Section III of its opening brief¹² that an ALJ must confine her review of data in prior approval rate hearings to the data (updated or otherwise) that was submitted to the CDI in support of the applicant's rate filing is rejected.

B. Overview of Insurance Code § 1861.05(a): Proposition 103

The statutes enacted through Proposition 103¹³, an initiative supported by a majority of voters in 1988, establish the system for the prior approval of insurance rates. Section 1861.05(a) provides:

¹¹ CDI RB pp. 1-8; Foundation OB, pp. 6-7.

¹² Foundation OB, pp. 11-19.

¹³ Proposition 103 is codified at Insurance Code §1861.01 *et seq.* All references to sections are to the Insurance Code unless otherwise indicated.

“No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter. In considering whether a rate is excessive, inadequate or unfairly discriminatory, no consideration shall be given to the degree of competition and the commissioner shall consider whether the rate mathematically reflects the insurance company’s investment income.”

The language in the first sentence “echoes similar language in the law of most states, as well as former section 1852 which it replaces.” (*Calfarm Insurance Co. v. Deukmejian* (1989) 48 Cal.3d 805 at p. 822.) However, the requirement of prior approval of rates marked a significant change in California law and the provision regarding investment income is unique.

The declared purpose of Proposition 103 is to regulate insurance rates by first rolling back prices to an affordable level and then to require justification for rate increases.¹⁴ As stated by the California Supreme Court: “If nothing else is clear, this is: Proposition 103 was intended to do away with the ‘open competition’ system. . . .” (*20th Century Ins. Co. v. Garamendi*, (1994) 8 Cal.4th 216 at p. 300.)

Section 1861.05 defines a range of reasonable rates between excessive and inadequate. The National Association of Insurance Commissioners (“NAIC”) has adopted a definition of an “excessive” rate which the ALJ finds sound and chooses to adopt here. The definition is as follows:

“A rate . . . is excessive if it is likely to produce a profit that is unreasonably high for the insurance provided or if expenses are unreasonably high in relation to services rendered.” 4 NAIC Model Insurance Laws, Regulations and Guidelines (1993) at 775-776 (Property and Casualty Model Rating Law, sections 4-5.)

¹⁴ Section 1 of Proposition 103 entitled “Findings and Declaration,” states, in pertinent part: “[E]normous increases in the cost of insurance have made it both unaffordable and unavailable to millions of Californians. [¶] [T]he existing laws inadequately protect consumers and allow insurance companies to charge excessive, unjustified and arbitrary rates. [¶] Therefore, the People of California declare that insurance reform is necessary . . . [I]nsurance rates shall be maintained at fair levels by requiring insurers to justify all future increases.” Section 2 of Proposition 103, entitled “Purpose,” states, in pertinent part: “The purpose of this chapter is to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians.” . . . (Historical and Statutory Notes, 42A West’s Ann. Ins. Code (1993 ed.) §1861.01, p. 649. See also, *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal.3d 805, 813.)

The California Supreme Court in the 20th Century decision also commented on the ‘excessive/inadequate’ provision of Insurance Code §1861.01 as follows:

“we must observe that the ‘excessive’/‘inadequate’ standard as defined in Proposition 103 is apparently ‘unique’ and without ‘precedent’ among ‘similar statutes. . . .’ . . . The insurers argue in substance that the ‘excessive’/‘inadequate’ standard as defined in the initiative should be interpreted in accordance with the insurance industry’s or actuarial professions’ understanding of its operative terms. We believe that subdivision (a) of Insurance Code section 1861.05, as quoted above, stands in the way.” (20th Century Ins. Co. v. Garamendi, *supra*, 8 Cal.4th at p. 289.)

The “excessive, inadequate” language of Insurance Code section 1861.05 contemplates a range of rates that are neither excessive nor inadequate, within which the insurer has discretion to choose. (See, *Calfarm Ins. Co. v. Deukmejian*, *supra* 48 Cal. 3d at pp. 822-823.)

C. The Regulatory Formula: California Code of Regulations, title 10, §§2641.1 et seq.

CCR §2641.1 states that “[t]his subchapter is adopted to implement the provisions of Proposition 103, governing approval of insurance rates.” The regulations are clear that “[w]hile companies remain free to formulate their rates under any methodology, the commissioner’s review of those rates must use a single, consistent methodology.” (CCR §2643.1.) The methodology the commissioner is to apply is set forth in a formula described in CCR §§2642.1 *et seq.* Various elements of the regulatory formula contain provisions in which the commissioner is to select a numeric value to be applied to given lines of insurance. SCPIE contends that because the commissioner has failed to select these generic determinations, the formula is incomplete and cannot serve as the standard of review in this matter.

CCR §2646.4(e) bans the relitigation of the regulations implementing Proposition 103.

The California Supreme Court in *20th Century*, *supra*, at p. 312 has clearly upheld this relitigation ban.

“... [t]he effect of the ‘relitigation ban’ is unobjectionable. In adjudication, the judge applies declared law; he does not entertain the question whether its underlying premises are sound. That is as it should be. Otherwise, standardless, ad hoc decision making would result. Similarly, in quasi-adjudicatory proceedings, the administrative law judge applies adopted regulations; he does not entertain the question whether their underlying premises are sound. That is also as it should be, and for the same reason.” *Id.*

SCPIE’s challenge to the ALJ’s use of the regulatory formula as the method of review in this hearing is impermissible relitigation. Arguably, the problems created by the lack of generic determinations for prior approval proceedings may be perceived as leading to the type of “standardless ad-hoc decision making” that was abjured in *20th Century*, *supra*, at p. 312, and as vitiating the formula’s goal of reducing the rate review task to a manageable size. However, where the Commissioner has not promulgated a numerical value for a generic factor in a given line of insurance, values can be selected using generally accepted actuarial principles, expert judgment and standards of reasonableness. Barring explicit direction from the legislature or the commissioner, the ALJ must apply the regulatory formula when determining whether SCPIE’s rate request is reasonable. SCPIE has not provided authority for ignoring the regulations in the face of their clear legal applicability.

By the same token, the Foundation has offered no legal authority to support its argument that an ALJ must confine her review to the data submitted in support of the original rate filing.¹⁵ Nor does the Foundation offer facts that suggest it was prejudiced by any evidentiary ruling in this proceeding. Indeed, the parties stipulated that all testimony that was not stricken and all exhibits identified in the Joint Exhibit List submitted on June 20, 2003, were admitted into

evidence. The parties also have conceded that an insurer could use a method other than the regulatory formula to prove up the rate application submitted to the CDI rate filing bureau.

Since the question before the ALJ in a prior approval hearing is whether the evidence the applicant/insurer submits is reliable when used in the regulatory formula, it does not matter if the insurer initially used other methods or data to support the rate request on its rate application submitted to the CDI's rate filing bureau. Furthermore, the discovery provisions contained in the regulations ensure that all interested parties are allowed access to the data ultimately used to support the rate request at the prior approval hearing. The ALJ was not made aware of any discovery disputes prior to the close of discovery or the evidentiary hearing.

Accordingly, the arguments of SCPIE and the Foundation on these matters are rejected. The ALJ must use the regulatory formula to review SCPIE's rate increase request, based on the evidence that has been admitted in this proceeding.

D. Burden of Proof

SCPIE also contends that the Foundation bears the burden of proof in this matter because: (a) Insurance Code §1861.05(b) only places the burden of proof on the applicant during the rate review process and not during a rate hearing; and (b) the CDI already had approved SCPIE's rate increase prior to the evidentiary hearing. (SCPIE's OB, pp. 7-9.) SCPIE is incorrect.

Proposition 103 specifically places the burden of proof on the applicant. Insurance Code section 1861.05(b) states that "the applicant shall have the burden of proving that the requested rate change is justified and meets the requirements of this article." The regulations mandate that the burden of proof is on the insurer/applicant. In Article 6 of the regulations, entitled "Procedures for Determination of Rates," CCR §2646.5 states, in pertinent part: "[T]he insurer

¹⁵ Foundation OB, p. 19.

has the burden of proving, by a preponderance of the evidence, every fact necessary to show that its rate is not excessive, inadequate, unfairly discriminatory. . . .” Thus, the applicant bears the burden of proof in a rate case prior to a rate becoming effective and after a rate is in effect. (*See*, CCR §2646.4(a).) Furthermore, while the commissioner must approve a rate when it is within the range of reasonableness, if the insurer fails to meet its burden, expert testimony need not be offered to support a rate disapproval.

III. ANALYSIS OF PROPOSED RATE USING THE REGULATORY FORMULA

Background

Pursuant to the regulations, the commissioner must use a single, consistent methodology to review rates. (CCR §22643.1.) Except as otherwise provided, rates are to be computed on the basis of premium charged per exposure. (CCR §2643.2.) The determination of whether rates are excessive or inadequate is made on the basis of the aggregate earned premiums that rates are expected to produce. (CCR §2643.3.) Statutory accounting principles rather than generally accepted accounting principles shall be used to measure equity. (CCR §2643.45)

The Foundation maintains that SCPIE’s proposed rate increase of 15.6% will lead to an excessive rate under the regulatory formula set forth in CCR §2644.2 *et seq.* and should not be approved by the commissioner. SCPIE disagrees and offers three different methods to prove its case: (a) an “actuarial” method that does not use the regulatory formula; (b) a “SCPIE Generic” method using the regulatory formula with the generic determinations set forth in a CDI workshop notice; and (c) a “Model A Formula Approach” method using SCPIE data and applying them in

elements of the regulatory formula.¹⁶

In keeping with the holdings in this decision regarding the proper standard of review, the ALJ considered the evidence in the record that was relevant to proving whether SCPIE's proposed rate increase of 15.6% produced a premium that is within the maximum/minimum permitted range by applying the formula in CCR §2644.2 as follows:

$$\begin{aligned} &\text{Projected losses, + projected allocated loss adjustment expenses +} \\ &\quad \text{projected fixed expenses -- projected ancillary income} \\ &1.0 \text{ -- the variable expense factor -- the maximum profit factor +} \\ &\quad \text{the investment income factor.} \end{aligned}$$

SCPIE and the Foundation submitted evidence on each of the formula's elements in support of their respective positions. When the regulations prescribed a specific sub-formula for determining an element, the parties followed that sub-formula and came up with the following results: Projected Fixed Expenses (0.9967)¹⁷; Projected Ancillary Income (4.7); Variable Expense Factor (4.3%); Investment Income Factor (18.9%); Projected Yield (5.6%); Reserve Ratio (3.375).¹⁸

The elements of the regulatory formula that are in dispute involve the calculation of: (a) SCPIE's projected losses, including SCPIE's loss and ALAE development and loss and ALAE

¹⁶ At the evidentiary hearing, SCPIE submitted Exhibit 35, a chart that depicted various elements of the regulatory formula and compared the results of Mr. Schwartz's rate indication analysis with the rate indications produced by SCPIE's "Generic Model" and SCPIE's "Model A Formula Approach." Following the evidentiary hearing, SCPIE updated Exhibit 35 with Exhibit 37. In response to requests by the ALJ, SCPIE recalculated the indicated rate change using the ratemaking elements under SCPIE's "Model A Formula Approach," different combinations of selections for ancillary income, federal tax rate, and rate of return and including the DD&R losses and ALAE in SCPIE's historical losses rather than as a separate provision. The results of these calculations are depicted in SCPIE Exhibit 45 and Exhibit 51.

¹⁷ The Foundation's Projected Fixed Expense equaled 0, a negligible difference that ultimately was not disputed.

¹⁸ See, SCPIE Exhibit 38. Based on the record, the specific elements of the regulatory formula on which there is no apparent dispute are: Excluded Expenses, CCR § 2644.10; Expense Trend, CCR §2644.11, Efficiency Standard, CCR §2644.12; Projected Ancillary Income, CCR §2644.13; Variable Expense Factor, CCR 2644.14; Leverage

trends; and (b) SCPIE's maximum profit factor, specifically SCPIE's rate of return. SCPIE also urges an interpretation of the regulatory formula that would permit SCPIE to separately develop and trend its losses associated with its Death, Disability and Retirement benefit and to calculate its federal income tax rate based on the actual income and expenses it anticipates under the proposed rates. The ALJ finds these arguments are not supported by the regulations.

Summary of Findings

The ALJ finds that the regulations do not permit SCPIE to separately develop and trend its Death Disability and Retirement losses or calculate its federal income tax rate on the premium and expenses it would earn under the proposed rates. SCPIE's projected losses and ALAE as developed and trended on Exhibit 51, p. 0507 are reasonable. The evidence in the record does not support SCPIE's maximum profit factor, which is based on a 15% rate of return. As a consequence SCPIE has failed to meet its evidentiary burden of proving that its requested rate change of 15.6% does not produce premium that is in excess of the maximum permitted earned premium as defined in CCR § 2644.2. However, on this record, SCPIE has proven that a rate change of 9.9%, based on a 10.7% rate of return, will not produce premium that is in excess of the maximum permitted earned premium as defined in CCR § 2644.2.

A. Projected Losses: CCR §2644.4

Pursuant to CCR §2644.4(a), projected losses are defined as the insurer's historic losses per exposure that are adjusted for: (a) catastrophes as prescribed in CCR §2644.5; (b) anticipated payout patterns (loss development) as prescribed in CCR §2644.6; and (c) forces not reflected in historical data that are expected to affect losses in the rating period (loss trend) as prescribed in CCR §2644.7.

The projected losses for medical malpractice insurance are adjusted only for loss development and loss trend since medical malpractice is not one of those insurance lines where catastrophes occur. (CCR §2644.5.) In addition, CCR §2644.4(b) mandates that projected losses for medical malpractice insurance shall be calculated by applying the loss trend factor separately to data from each report year since the use of claims-made policies predominates throughout this insurance line.

As a general background to the discussion on projected losses, SCPIE's Assistant Vice President and Associate Actuary, Mr. James Robertson, testified that SCPIE based its rate request, in part, on the 2003 Rate Study prepared by Tillinghast's actuary, James Hurley. The 2003 Rate Study suggested indicated rate changes based on two models denoted Model A and Model B. The indicated rate changes in both models are based on the use of various assumptions of SCPIE's projected losses and expenses, or interpretations of past loss and expense trends.¹⁹ Model A proposed a rate change of 32.4% over the present rate and Model B proposed a rate change of 14.2%.²⁰ According to Mr. Hurley, the 2003 Rate Study provided SCPIE with a range within which SCPIE could select a rate for the 2003 policy year because it is difficult to predict how much to charge for medical and malpractice insurance coverage given the low frequency/high severity nature of the claims filed under this type of policy.²¹ Mr. Hurley considered the estimates for ultimate losses presented in the two models to be within the range of reasonableness.

1. Loss Development: CCR §2644.6

Ratio, CCR §2644.21; and Surplus Ratio §2644.22.

¹⁹ WT Mr. Robertson, January 29, 2003, pp. 3-4.

²⁰ WT Mr. Hurley, January 27, 2003, p. 4.

Loss development refers to the change in the value of a group of claims over a period of time. A common method for estimating future loss development is through the application of a loss development factor which is a numeric multiplier applied to claims data to project the ultimate costs of the claims for a report year.

The regulatory formula requires that loss development be presented as a “loss-development triangle, based on the average of the ratios of losses for the three most recent accident-years available for a reporting interval.” (CCR§2644.6.)

SCPIE’s first round of testimony on the issue of projected losses did not follow the precepts of the regulatory formula. Following the evidentiary hearing, Mrs. Bass, SCPIE’s expert actuary, submitted Exhibit 38 which is a “trued-up” version of SCPIE’s rate application. Instead of using the developed losses from the Tillinghast 2003 rate study, as was done with SCPIE’s original rate application, Exhibit 38 reflects the use of 3- year average loss development factors in accordance with CCR 2644.6²². The loss development factors are the same as those generated by the Foundation’s witness, Mr. Schwartz. The Foundation does not dispute the results regarding this component of the rate calculation.²³ However, Mr. Schwarz testified that his research revealed SCPIE historically has selected excessive loss development factors. Mr. Schwartz claims this finding is consistent with his research that demonstrates SCPIE also has a history of setting excessive reserves and inflating its reported losses.²⁴ The implication is that the currently proposed factor should be smaller because of the historical pattern.

²¹ WT Mr. Hurley, January 27, 2003, pp. 4-5.

²² WT Mrs. Bass, May 17, 2003, p. 3.

²³ WT Mrs. Bass, March 19, 2003, pp. 1-2; WT Mr. Schwartz, May 20, 2003, p. 5; Foundation Exhibit 101, p. 0004; SCPIE Exhibit 38, p. 0434..

²⁴ WT Schwarz, March 17, 2003, pp. 12-16; WT Mr. Schwartz, March 10, 2003, pp. 13-14; Foundation Exhibits. 142 & 143, pp. 0293-0294.

Mrs. Bass refutes Mr. Schwartz's allegation that, since SCPIE's estimates for ultimate losses were too high in prior years, they also are too high in SCPIE's current rate application. Mrs. Bass claims that one must consider the current rate application only on the data, methods and assumptions used to support it, not on the data and results related to prior rate applications.²⁵

Mr. Schwartz testified that SCPIE's financial statements prove SCPIE's loss reserves in prior years were too high.²⁶ Mrs. Bass testified that Mr. Schwartz's reasoning and conclusions are faulty because the information contained in the financial statements has nothing to do with the data contained in SCPIE's original or "trued-up" rate applications which are based on different reserves. The reserves on SCPIE's financial statement include: (1) case reserves that are the sum of the case reserves individual adjusters have placed on individual cases still pending as of the valuation date of the financial statement; and (2) an IBNR reserve ("incurred but not reported") that is a bulk reserve. The IBNR reserve is not claim specific but one amount for the entire line or segment of business that is established to provide for the situation in which the claims adjuster's estimated reserves are inadequate to pay for all the claims when they are finally settled. The loss data on the rate application, on the other hand, only reflects paid losses plus the case reserves that specifically exclude the IBNR reserves.²⁷

Mr. Robertson testified that SCPIE has no incentive to over-reserve its claims because loss and ALAE reserves drain statutory surplus causing the premium to surplus ratio to rise, a situation that is negatively viewed by the public and makes it harder to write more business. Mr. Robertson added that over-reserving could also trigger more regulatory scrutiny. According to

²⁵ WT Mrs. Bass, April 2, 2003, p. 2. At the ALJ's request, SCPIE filed a corrected copy of Mrs. Bass's April 2, 2003, rebuttal testimony on May 1, 2003. The corrected testimony was not resigned and dated, but attached to additional testimony by Mrs. Bass dated April 30, 2003. All further citations to Mrs. Bass's April 2, 2003, testimony will be to the corrected version.

²⁶ RT Vol. III, pp. 59-60.

Mr. Robertson, insurers do not reduce the risks associated with volatile lines of business by setting their claim reserves high, they protect their business from volatility by maintaining a surplus that is high relative to premiums written and/or by purchasing reinsurance²⁸.

Based on the evidence, there is no dispute that, for the current year, SCPIE appropriately calculated SCPIE's loss development as set forth in CCR §2644.4. Mr. Schwartz's conclusions regarding SCPIE's past selections of ultimate loss factors and its past reserving practices are not persuasive when weighed against SCPIE's testimony on this issue. We therefore conclude that SCPIE's loss development factors as set forth in Exhibit 38 in line items 8(a)-(c) are reasonable in the present case and should not be reduced. However, as indicated below, we also conclude that the losses and allocated loss adjustment expenses associated with SCPIE's Death Disability and Retirement (DD&R) coverage should be included in SCPIE's historical experience rather than removed and trended as a separate provision.

2. Loss Trend: CCR §2644.7

Projected ultimate losses also are adjusted to reflect both the anticipated severity (average claim size) and frequency (number of claims) from the experience period until the new rates are in effect. The process of applying a trend factor (numeric multiplier) to the projected ultimate losses and revaluing them on the cost basis for the future effective period is called trend adjustment.

CCR §2644.7 mandates that loss trend shall be based on the exponential curve of best fit, as measured by the coefficient of determination and as modified by the commissioner to take into account factors not reflected in the historical data. Since the commissioner has not adopted generic determinations for loss trend factors, the parties agree that standard actuarial procedures

²⁷ WT Mrs. Bass, April 2, 2003, pp. 2-3.

can be used to develop the loss trends. However, the parties differ on the best method for trending in this case. The ALJ finds SCPIE's loss trend of 1.065 to be reasonable and supported by the weight of the evidence.

i. SCPIE's Trend Method

SCPIE's selected an overall loss trend factor of 1.065.²⁹ Mr. Hurley developed the loss trend factor in a two step process that involved: (1) using the ultimate loss estimates developed in Model A³⁰ of the Tillinghast 2003 rate study; and (2) analyzing the annual change in the severity of the claims and the annual change in the frequency of the claims through a variety of statistical curve-fitting models.³¹

Mr. Hurley testified that he calculated the ultimate loss estimates in Model A based on 8 different but valid projection methods and on the ultimate losses Tillinghast selected as of December 31, 2002. These projection methods are depicted in columns 1-9 in SCPIE Exhibit 49. Mr. Hurley then rounded the numbers in columns 1 through 9 at the upper range to get the ultimate loss selection shown in column 10 of Exhibit 49.³² The ultimate loss estimates in Model A are towards the high range of what SCPIE's ultimate losses will be during the rate period.³³

²⁸ WT Mr. Robertson, April 2, 2003, p. 8.

²⁹ Mr. Hurley, January 27, 2003, pp. 4-5.

³⁰ SCPIE's trend factors in its original rate application came from Model B in the Tillinghast 2003 rate study. The difference between the severity trend factors of Model A and B is the different estimates of ultimate losses each model produces. Model A and Model B showed the same frequency levels and trends.

³¹ WT Mrs. Bass, January 29, 2003, pp 15-16; WT Mrs. Bass, May 17, 2003, p. 3; WT Mr. Hurley May 1, 2003, p. 3; Exhibit 48, pp.0488-0489.

³² SCPIE Exhibit 49, p. 0491.

³³ WT Mr. Hurley, May 1, 2003, pp. 3-4; SCPIE Exhibit 49, p. 0491. Model B was based on only two projection methods shown in Col. 4 (adjusted reported losses) and Col. 8 (adjusted paid on closed projections) in SCPIE Exhibit 49, p. 0492. The results from the 2 projection methods were then rounded toward the lower end of the range. The ultimate loss estimates in Model B represent the low range of what SCPIE's ultimate losses will be during the rate period.

After he selected SCPIE's ultimate loss amounts for Model A, Mr. Hurley calculated SCPIE's basic limits ultimate severities and graphed them.³⁴ A uniform trend was fitted to the severity of claims from 1997 to 2001.³⁵ In Mr. Hurley's opinion, the selection of the period from 1997 to 2001 is reasonable as it is sufficiently mature enough as of March 31, 2002, to make a determination about the severity trend in the future.³⁶ Mr. Hurley observed that the loss severities depicted in SCPIE Exhibit 47 on page 0487 showed an upward change in pattern ("turning point") beginning in 1997. Thus, in 1996, the severity was \$51,524, while in 1997, the severity was \$54,101 and higher afterwards.³⁷ Mr. Hurley concluded that upward trend beginning in 1997 would continue into 2002 and 2003.³⁸ In response to this observed turning point, Mr. Hurley calculated a 5% trend factor to capture the change in the data after 1997.³⁹

SCPIE also tested the upward trend against data from a closed-claims severity study conducted by CAPP – Californians Allied for Patient Protection. This study collected data from the major California physician insurers, added it together and calculated the average for each year. The CAPP study, based only on paid dollar amounts, indicated an upward trend in loss amounts (severity) similar to the upward trend in severity that SCPIE noted in its own loss data. Although Mr. Hurley typically would not use CAPP data in a rate filing, he testified that such studies are useful in confirming the trend of severity data.⁴⁰

SCPIE maintains that there is a trend in the higher limits of coverage as well. In order to measure this trend, Mr. Hurley prepared a log normal increased limits factor model from a study

³⁴ SCPIE Exhibit 47, p. 0484.

³⁵ SCPIE Exhibit 47, p. 0487.

³⁶ WT Mr. Hurley, January 27, 2003, p. 9-11.

³⁷ WT Mr. Hurley, May 1, 2003, p. 4; SCPIE Exhibit 47, p. 0484.

³⁸ WT Mr. Hurley, January 27, 2003, p. 10.

³⁹ WT Mr. Hurley, May 1, 2003, p. 4; SCPIE Exhibit 47, p. 0487.

⁴⁰ WT Mr. Hurley, April 2, 2003, p. 4.

of SCPIE data completed several years ago.⁴¹ The prior increased limits trend factors (ILF) were used to calculate the average annual change in ILFs to reflect the trend in claims for excess layers of coverage. The results of this calculation produced a trend of 2.8⁴²

Since the data from the underlying study is no longer available, Mr. Hurley tested its assumptions to see if they were still valid for the current environment using the data contained in the Tillinghast 2003 rate study. The first test calculated the trends by fitting a least-square regression to severities for three different time periods spanning a period between 1995 and 2001. The second test compared the ratio of the average claim severity for the \$1 million limit to the average claim severity for the basic limit over time and fit these data using a least-squares regression.⁴³ According to Mr. Hurley, both tests demonstrate that the 2.8% increased limits trend is reasonable.⁴⁴

Mr. Hurley also calculated SCPIE's report year ultimate claim frequencies and graphed them.⁴⁵ A uniform trend was fitted to the frequency of claims from 1987 to 2002.⁴⁶ Mr. Hurley noted a downward trend in frequency beginning in 1996 which is reflected in the -1.3% trend selection and a negative frequency trend carried forward to 2003.⁴⁷ Based on the foregoing, SCPIE selected an overall loss trend of 1.065.

ii. The Foundation's Trend Method and Criticism of SCPIE's Approach to Trending

⁴¹ WT Mr. Hurley, April 2, 2003, pp. 1, 5-6; SCPIE Exhibit 1, p. 0064

⁴² WT Mr. Hurley, April 2, 2003, p. 6; SCPIE Exhibit 1, p. 0064.

⁴³ WT Mr. Hurley, March 4, 2003, pp. 3-4; SCPIE Exhibit 25, pp. 0303-0305.

⁴⁴ The data used in the Model A analysis is contained in the SCPIE Rate Study of June 2002. SCPIE Exhibit 47, pp. 0484-0485, 0487 show the calculation of the severities, trend selections and supporting trend graphs. The source and backup for the underlying data and projections are contained in SCPIE Exhibit 49, pp. 0490-0491.

⁴⁵ SCPIE Exhibit 47, p. 0483.

⁴⁶ SCPIE Exhibit 47, p. 0486

⁴⁷ SCPIE Exhibit 38, p. 0413; SCPIE Exhibit 47, p. 0486; WT Mr. Hurley, January 27, 2003, p. 11,

Mr. Schwartz calculated loss trend factors by fitting mathematical curves to SCPIE's historical data over six different time periods to determine the average annual trend. Based on this regression curve method, Mr. Schwartz concluded that the relatively shorter term pure premium trends (8 years or less) have been downward, while the relatively longer pure premium trends (12 or more years) have been moderately upward. The average of all Mr. Schwartz's annual trend indications are as follows: severity factor = +1.0%, frequency factor = -1.7% and pure premium factor = -0.7%.⁴⁸ The overall loss trend factor is stated as 1.000.⁴⁹

The Foundation's criticism of SCPIE's approach to trending initially focused on SCPIE's rate filing based on data from Tillinghast's 2003 rate study, Model B. According to Mr. Schwartz, Mr. Hurley's selection of trends, based on the ultimate loss data in Model B, the so-called "turning points" and on his judgment, fails to provide an adequate explanation for how the claim severity and claim frequency loss trend factors were selected. The Foundation also argues that SCPIE's increased limits annual trend is based upon numerous unsupported assumptions contained in the 10-year old Tillinghast rate study that no longer exists and on questionable data from the severity study compiled by CAPP.⁵⁰

When it became apparent to SCPIE that the ALJ was going to review SCPIE's rate request by using the regulatory formula, SCPIE submitted evidence in support of its rate request on data derived from Tillinghast's Model A rather than on Model B. In response, Mr. Schwartz testified that: (1) SCPIE Model A is not consistent with his understanding of the loss

⁴⁸ WT Mr. Schwartz, March 9, 2003, p. 21; Foundation Exhibit 104, p. 0015-0020.

⁴⁹ SCPIE Exhibit 38.

⁵⁰ WT Mr. Schwartz, March 9, 2003, pp. 26-27; Foundation OB p. 21-24.

development portion of the ratemaking regulations; and, (2) a mathematical analysis of the applicable loss data does not support the upward turning point in the trend alleged by SCPIE.⁵¹

According to Mr. Schwartz, loss development enters into the rate calculation in two different places: (1) the level of losses on an historical basis; and (2) the losses used to determine trend factors. Mr. Schwartz does not contest the values used by SCPIE to determine the level of losses on an historical basis. However, Mr. Schwartz disagrees with SCPIE's use of the projected ultimate losses developed under SCPIE Model A to determine its loss trend factors.⁵² In his opinion, none of the loss projections, depicted in SCPIE Exhibit 49 p. 0491, that SCPIE used to develop loss trend is based upon the 3 year average method set forth in the regulations. Furthermore, since the projected losses in Model A are inflated (see pp. 14-15, supra.) Mr. Schwartz contends that the loss trend values derived from this model also are inflated, distorted and excessive.⁵³

Mr. Schwartz also testified that the use of a mathematical procedure called double exponential smoothing ("DES") on the applicable data proves that there is no upward turning point in the trend as alleged by SCPIE. According to Mr. Schwartz, the DES method takes into account the most recent data and has been used by the California Workers' Compensation Insurance Rating Bureau (WCIRB) in calculating proposed rates for workers' compensation insurance. When applying the DES model, a constant trend value is not assumed over the entire time period but the trend is allowed to move up and down by year to reflect the most recent data.⁵⁴ Any turning point in the experience would be reflected in the annual trends. The results

⁵¹ WT Mr. Schwartz, May 13, 2003, p. 10; Foundation Exhibits 169-171, pp. 0414-0428.

⁵² WT Mr. Schwartz, May 20, 2003, pp. 2-4.

⁵³ WT Mr. Schwartz, May 20, 2003, pp. 4-5.

⁵⁴ SCPIE Exhibit 171, p. 422.

of Mr. Schwartz's application of the DES model to the losses for both severity and frequency do not support SCPIE's contention that there is an upward turning point in its loss data.⁵⁵

iii. Discussion

In weighing the evidence presented on the issue of loss trending, we find SCPIE's method and trend factors to be reasonable. The Foundation's claims⁵⁶ that SCPIE's use of the Tillinghast Model A data is contrary to the regulations and that SCPIE's trending methodology is not sound.

CCR §2644.7 states, in pertinent part that "[T]rend factors shall be based on the exponential curve of best fit, as measured by the coefficient of determination, and as modified by the commissioner to take into account factors not reflected in the historical data." However, CCR §2644.7 does not specifically limit the historical data used for trending to the most recent three years and, absent the commissioner's selection of a generic determination for trends, the insurer may use generally accepted actuarial principles, expert judgment and standards of reasonableness to determine its loss and ALAE trend factors.

Since there is no guidance on the number of years to use in trending, the ALJ thinks it is reasonable to use a relatively short time frame on which to fit a curve for trend, in order to be most responsive to recent trends. Mr. Schwartz's conclusion that SCPIE failed to provide an adequate explanation for how SCPIE selected its claim severity and claim frequency loss trend factors is not convincing in light of Mr. Hurley's and Mrs. Bass's testimony on SCPIE's methodology. SCPIE's approach was not unreasonable. SCPIE reviewed graphical presentations of the historic frequency and severity, identified "turning points" where the data changed direction from year to year and selected trend factors for the periods according to the

⁵⁵ WT Mr. Schwartz, May 13, 2003, pp. 11-12.

data. Mr. Hurley's claims that this type of analysis is appropriate for volatile lines like medical malpractice and that the analysis is not a mechanical process and requires experience and familiarity with medical malpractice loss experience to exercise reasonable judgment is persuasive.⁵⁷

Mr. Schwartz's regression curve analysis, on the other hand, over-smoothes the trend reflected in SCPIE's data. As Mr. Hurley testified, an actuary normally would fit a mathematical curve to data and then test the fit of the curve to the data by either examining correlation coefficients or graphic inspection. Instead, the evidence indicates that Mr. Schwartz assumed one mathematical curve (exponential) and mechanically ran regressions for 12 different grouping of years for each component of trend using the same set of time periods without regard to the correlation coefficient or what the graph of the data looked like. This type of analysis gives the appearance of mathematical precision but it is not responsive to the data. Rather, Mr. Schwartz's calculations create a range that has little relevance to what the data is actually doing for the period to which SCPIE is applying trend and leaves the impression that SCPIE's selections are on the "high side of being above a reasonable indicated average."⁵⁸

Mr. Schwartz's regression curve methodology often misses the turning points in the data because of its smoothing nature. Specifically, Mr. Schwartz's use of regression curves on the 1998-2000 data ignores the fact that beginning in 1999, the data is very different from the pre-1999 trend. According to Mrs. Bass, Mr. Schwartz simply rolls all four observations of the regression curves together and forces a curve of best fit onto the data to arrive at a calculated

⁵⁶ Foundation OB, p. 18.

⁵⁷ WT Mr. Hurley, April 2, 2003, p.1.

⁵⁸ WT Mr. Hurley, April 2, 2003, pp. 2-3.

trend of 0.4% for the four most recent points. The result of +0.4% suggests that there is very little trend during this four-year period or that very little trend can be expected in the future.⁵⁹

However, Mr. Schwartz neglects to mention that the R-squared value for his regression analysis is 0.014. Mrs. Bass defines the R-squared value in this context as a measure of the “goodness of fit” of the regression model. More specifically, it is the percentage of the total variation in claim severity that is explained by time trend alone, in other words, the higher R-squared value, the more reliable the model. Thus, if 80% or 90% of the variation in severity were explained by the trend over time, one would have a good deal of confidence that the model was a fair representation of the trend in severity. The R-squared value of .014 on Mr. Schwartz’s regression curve results explains only 1.4% of the variation in claim severity over time. In contrast, Mrs. Bass fit the data for the most recent 3 years to a regression curve and got an annual trend of +4.9%. Mrs. Bass’s 3-year model has an R-squared value of 0.938. The +4.9 trend explains 93.8% of the variation in severities over time.⁶⁰

The tendency of Mr. Schwartz’s choice of methodologies to flatten or smooth the data is supported by Dr. Appel’s testimony. SCPIE’s expert economist criticizes Mr. Schwartz’s use of the double exponential smoothing method (“DES”) to support his conclusion that SCPIE’s data does not show an upward turning point in the trend. Dr. Appel was unable to find any reputable source that asserts that this method can be used to identify turning points in data and believes it is a mistake to portray a smoothing procedure as a procedure for identifying turning points. It is reasonable to conclude from the evidence that DES could cause turning points to disappear by its nature of smoothing away fluctuations.⁶¹

⁵⁹ WT Mrs. Bass, April 2, 2003, p 4-5.

⁶⁰ WT Mrs. Bass, April 2, pp. 5-6.

⁶¹ WT Dr. Appel, May 16, 2003, pp. 2-3.

Furthermore, the DES technique is inconsistent with the trend methodology outlined in CCR §2644.7, which states that “trend factors shall be based on the exponential curve of best fit as measured by the coefficient of determination....” According to the evidence, double exponential smoothing is not a statistical technique used to fit a curve to data. Rather, it is simply a mechanical method of smoothing a data series to remove “noise” so that an analyst might better discern patterns in the data. Since DES is not a statistical estimation technique and does not produce “fitted” values that can be compared to actual values, this method cannot produce a coefficient of determination (R- squared).⁶²

While Mr. Schwartz claims the WCIRB used the DES technique for estimating trend in the WCIRB’s loss cost filing, based on Dr. Appel’s testimony, the ALJ does not believe this technique is a valid approach in the current case. Workers’ compensation insurance is exempted from and is not a regulated line of insurance under Proposition 103. The WCIRB suggests indicated pure premium rate increases – it is not a fully loaded rate – and it does it every year or more often for the entire California workers’ compensation insurance industry. Therefore, there is less need to react to a turning point and more reason to smoothe outliers.

Finally, Mr. Schwartz failed to provide documentation of the actual equations he used to support his results in Foundation Exhibit 171 and Dr. Appel was unable to replicate these same results when he used the exact method relied on by Mr.. Schwartz.⁶³ Accordingly, the DES approach does not appear to be a reliable tool to measure turning points in trend and the conclusions Mr. Schwartz reaches from its use do not carry much weight in this proceeding.

In conclusion, for the foregoing reasons, SCPIE’s 1.065 loss trend factor is reasonable.

3. SCPIE’s Death Disability & Retirement Provision (DD&R)

⁶² WT Dr. Appel, May 16, 2003, pp. 1-2.

SCPIE included a DD&R factor of 1.047 (4.7%) in its SCPIE Model A formula analysis to reflect future DD&R losses. SCPIE contends that a separate DD&R load to SCPIE's projected losses is warranted by the facts and is not contrary to the regulatory formula.

The ALJ finds that the regulatory formula does not provide for the separate development and trending of SCPIE's DD&R losses and costs. CCR §2644.4 provide for the adjustment of historic losses by (1) catastrophe, (2) loss development and (3) loss trend. CCR §2644.8 defines projected allocated loss adjustment expenses as the company's historic costs per exposure associated with the adjustment of specific claims and states that these costs are to be developed and trended in the same manner as historic losses.

According to CCR §2644.6, loss development is the process by which "reported losses" are adjusted for anticipated payout patterns. DD&R claims are reported losses under SCPIE's policy and their removal from the historical data-base may alter the results of the historical loss and ALAE development as mandated by the formula. Therefore, the DD&R losses and ALAE should be included with SCPIE's other historical losses and ALAE for purposes of development and trending absent clear regulatory language to the contrary. Since no such provision exists in the regulatory formula, the ALJ has no authority to allow SCPIE to remove its DD&R losses and ALAE from the historical data. (*See, Jurcoane v. Superior Court* (2001) 93 Cal.App.4th 886, 894; *20th Century, supra* at p. 312.)⁶⁴

B. Projected Allocated Loss Adjustment Expenses: CCR 2644.8

⁶³ WT Dr. Appel, May 16, 2003, p. 2

⁶⁴ The ALJ reviewed all the evidence and arguments in support of and against the use of a separate DD&R factor and ultimately found SCPIE's evidence unpersuasive on this issue. SCPIE's underlying studies in support of a 1.047 DD&R factor were based on so many assumptions that the reliability of the factor has to be questioned. SCPIE's evidence that its policyholders were aging was effectively countered by an opposing study completed by Mr. Schwartz indicating the contrary. Thus, both on a legal and factual basis, SCPIE's contention is rejected.

Costs incurred by insurance companies in settling claims are called loss adjustment expenses. These costs include attorney fees, court costs, independent claims adjusters, outside experts, appraisals, salaries and related overhead. These costs are divided into two categories: (1) allocated loss adjustment expenses (ALAE) which are cost associated with a particular claim, such as legal fees; and (2) unallocated loss adjustment expenses (ULAE) which are costs not associated with a particular claim but with the general overhead of the insurer in investigating and settling claims, such as the salaries for claims adjusters.⁶⁵

SCPIE and the Foundation used the same data and 3-yaer average method mandated by CCR §2644.8 to derive ALAE development. The parties do not dispute these calculations but, disagree on the best method for trending ALAE. SCPIE selected an ALAE trend of 1.069 based on the same “turning point” analysis it performed to determine its loss trend factor under the regulatory formula. The Foundation selected an ALAE trend factor of 1.035 based on the regression model analysis. The parties essentially reiterated the same criticisms of each other’s ALAE trending methodology as they expressed towards each other’s loss trending methodology.

For the same reasons as stated in Section A on Projected Losses, the ALJ finds that SCPIE’s ALAE trend analysis based on the Model A 2003 Rate Study data and the resulting ALAE trend of 1.069 is reasonable for the 2003 policy year.

C. Maximum Profit Factor: CCR §2644.15

Pursuant to CCR §2644.15, the maximum profit factor means the maximum permitted after-tax rate of return divided by the product of the leverage factor and multiplied by the federal income tax factor. Stated as formula, the maximum profit factor is:

$$\text{Maximum Profit Factor} = \frac{\text{Maximum Permitted After Tax Rate of Return}}{(\text{Leverage Factor} \times \text{Federal Income Tax Factor})}$$

⁶⁵ WT Mr. Schwartz, March 9, 2003, p. 27.

The commissioner has yet to establish, in accordance with CCR §2646.3, the maximum and minimum permitted after-tax rate of return for property and casualty insurance or the leverage factor for each line of insurance. The federal income tax factor is determined by a formula set out in CCR §2644.18. The parties do not agree on what after-tax rate of return should be in the maximum profit formula. However, the parties agree that the leverage factor should be a value of 1.0 and they also agree that a strict application of the formula in CCR §2644.18 produces a federal income tax rate of 0%. SCPIE submits additional arguments in favor of using a different type of income tax analysis than that mandated by the regulatory formula. SCPIE's alternative approach for determining the income tax factor is rejected as explained below.

1. The Federal Income Tax Factor

CCR §2644.18 states, in relevant part, as follows:

- (a) "Federal income tax factor" means 1.0 minus the insurer's effective federal income tax rate reported in the most recent year for which historical data are available, giving full account to all tax credits and offsets used or available to the insurer. Where there has been a change in tax laws between the recorded period and the rating period, the effective tax rate shall be calculated using the historical data and the tax rules for the rating period.
- (b) Where the insurer had a net tax credit, . . . the effective tax rate shall be zero and (1) . . . the amount of the credit shall be added, as a positive number, to nationwide projected ancillary income."

The Foundation calculated a federal income tax rate of 0% based on the fact that SCPIE had a 2001 net tax credit.⁶⁶ SCPIE concedes that a strict application of the federal income tax sub-formula produces a 0% federal income tax rate. However, SCPIE argues that this sub-

⁶⁶ Foundation Exhibit, 110, p. 0032.

formula is internally inconsistent with the balance of the regulatory formula that is prospective in approach. SCPIE contends that because ratemaking is prospective, it must reflect the actual income and expenses the insurer anticipates under the proposed rates. Therefore, since SCPIE will not earn a tax credit under the proposed rates, SCPIE should be able to use a tax rate based on expected income.⁶⁷

While interesting, SCPIE's argument is contrary to the clear and unambiguous language of the regulations. Based on the evidence, the ALJ finds CCR §2644.18 mandates that SCPIE's federal income tax rate provision is 0% for the 2003 rate year. The federal income tax factor is equal to 1.0.

2. The Maximum Permitted After Tax Rate of Return

Using its Model A formula approach, SCPIE initially selected a 15% after-tax rate of return and later indicated that the rate of return could be as low as 13%. The Foundation selected an 8.3% after-tax rate of return. SCPIE's rate of return approach relies heavily upon a risk analysis that is contrary to the mandates within the regulatory formula. Evidence in support of SCPIE's risk analysis is deemed not relevant to the rate of return issue. As explained below, SCPIE fails to introduce sufficient evidence to prove that an after tax rate of return of 15% or even 13% is reasonable for the 2003 rate period. On the other hand, the ALJ finds that SCPIE's cost of capital analysis is sound and the 10.7% rate of return SCPIE developed using this approach is reasonable.

i. Background

The maximum permitted after-tax rate of return for property and casualty insurance ratemaking is defined under CCR §2644.16 as follows:

⁶⁷ SCPIE OB, p. 27; SCPIE RB, pp. 24-25; WT Dr. Appel, March 7, 2003, pp. 3-4.

“The Commissioner shall, from time to time, determine, in accordance with section 2646.3, the maximum and minimum permitted after tax rate of return for property and casualty insurance ratemaking. The maximum and minimum profit factors shall represent the range of yields on investments in other enterprises presenting risks to investors comparable to property and casualty insurance, giving due consideration to the competing interests of investors and consumers, and taking into account the fact that insurance is imbued with the public interest and that its purchase is sometimes legally required.”

The regulations clearly state that the commissioner will select only one maximum and one minimum rate of return factor that will not vary from line to line.⁶⁸ However, CCR §2644.18 does not specify whether the risk of property and casualty insurance is based on the average line’s range of risk or an average of the range of risk of all lines combined.

Thus, the question to be resolved here is whether the competing interests identified in §2644.18 are best served when (1) the maximum profit factor is based on the maximum rate of return for the riskiest line of property and casualty insurance and the minimum profit factor is based on the least risky line of property and casualty insurance or, (2) the maximum and

minimum profit factors are based on the historical maximum and minimum reasonable rates of return for the average risk of property and casualty insurance whether the average line or the average of all lines combined.

To answer to this question one must first determine the function of the leverage factor in the maximum profit factor formula.

CCR §2644.17 states, in pertinent part, as follows:

- (a) “Leverage factor” means the ratio of net written premiums to surplus.”
- (b)[E]ach insurer’s surplus shall be allocated to its respective lines in proportion to the industry-wide reserves. In determining the leverage ratios, the commissioner shall give due consideration to regulatory standards of

⁶⁸ CCR §2644.17(c).

solvency and actual industry-wide, all lines ratio of net written premiums to surplus.

- (c) The Commissioner finds that investors' perceived investment risk may vary from line to line. In lines perceived to have higher risk, the commissioner may establish higher surplus requirements, and insurers may earn the rate of return on the higher surplus. **Thus, while the rate of return does not vary by line,** insurance perceived to have a greater risk will yield higher returns per premium dollar." (Emphasis added.)

As indicated in CCR §2644.17(c), the commissioner acknowledges that investment risk varies from line to line and he may establish leverage factors for each line of insurance that reflect their respective investment risk so that the lines perceived to have the greater risk will be allowed a higher return per premium dollar. The lower the leverage factor, the higher the risk of the particular line of insurance.

Applying the leverage factor in the rate of return analysis demonstrates how the regulatory formula takes into consideration the interests of consumers and investors. For example, applying the highest rate of return to all lines of insurance would be unfair to consumers because the premium rates would likely escalate. Alternatively, if the rate of return was based on the least risky line of property casualty insurance, the interests of investors would not be served. Adding a low leverage factor and a high rate of return to a risky line of property and casualty insurance, as SCPIE urges here, would overemphasize the risk to the detriment of the consumers as the Foundation argues.

In light of the foregoing, the ALJ finds that the various competing interests identified in CCR §2644.18 are reasonably balanced by applying different leverage factors to reflect the risk of a particular line of property casualty insurance and by applying one maximum/minimum rate

of return that is based on the historical maximum/ minimum rates of return for the average risk of property casualty insurance.

Therefore, when calculating the maximum profit factor, the ALJ must first decide what the maximum rate of return is for the average risk of property casualty insurance. In answer to this question, the Foundation submits evidence that 8.3% is the maximum rate of return that should be used in this case. SCPIE's evidence indicates the average cost of capital or reasonable rate of return for the average risk of property casualty insurance is 10.7%.⁶⁹

ii. Rate of Return Analysis

The parties agree that since the commissioner has not adopted the generic determination for the rate of return, they may use standard actuarial and financial principles to develop the after-tax maximum rate of return. SCPIE submitted testimony in support of the 15% rate of return based on how medical malpractice insurance lines, and SCPIE in particular, represent a greater than average investment risk. SCPIE argues that in determining the rate of return, the ALJ must consider evidence regarding the risk factors that SCPIE faces in the marketplace, such as the relative risk of its business in California and the mono-line status of the insurer.⁷⁰ The Foundation disputes this argument and contends that the rate of return should be based on the average risk line of property casualty insurance. Because of the leverage factor, this risk evidence is not relevant to the rate of return issue and is not further considered.

In addition to the risk analysis, Dr. Appel supported a 15% rate of return for SCPIE based on: (1) the CDI's Amended Notice of Workshop and Generic Determination hearing dated June 14, 2002, that stated "in the past, the Commissioner has allowed a maximum rate of return for

⁶⁹ WT Schwartz, March 17, 2003, p. 34; WT Dr. Appel, January 29, 2003, p. 19.

⁷⁰ SCPIE RB, p. 18; WT Dr. Appel, May 1, 2003, pp. 1-2.

ratemaking purposes of up to 15%”;⁷¹ and (2) Dr. Appel’s review of “recent rate filings in California that have utilized a 15% rate of return in determining the ‘maximum profit factor’ in the proposed rates.”⁷²

The ALJ finds that this evidence is not persuasive. The CDI Amended Notice of Workshop does not promulgate a rate of return regulation or even suggest the adoption of a 15 % rate of return for property and casualty insurance. The notice simply asks for public comment supporting a proposed maximum and minimum rate of return not to exceed 15%. Dr. Appel’s general comment about his review of other unidentified rate filings lacks sufficient specificity to be useful in this case.⁷³ As a consequence, SCPIE failed to prove by a preponderance of the evidence that a 15% rate of return is reasonable.

iii. The cost of capital for the average risk

Dr. Appel’s analysis relies on two “pre-eminent” market-based methods for estimating the cost of capital: (1) the discounted cash flow (“DCF”) model and (2) the capital asset pricing model (“CAPM”). Mr. Schwartz’s rate of return analysis also used these two methods.⁷⁴

The DCF model looks more closely at the data for the last five to ten years of historical experience and to the projections of earnings and returns in the future.⁷⁵ In order to implement the DCF model, estimates of the expected first year dividend yield and the expected dividend

⁷¹ SCPIE Exhibit 27, p. 0333.

⁷² WT Dr. Appel, March 7, 2003, pp. 1-2.

⁷³ RT, Vol. II, p. 114

⁷⁴ WT Dr. Appel, January 29, 2003, p. 16. Dr. Appel details the underlying data and assumptions for his DCF and CAPM analyses in an appendix to his January 29, 2003, testimony on pages 23-33. Dr. Appel further explains the underlying data in his cost of capital analysis in his testimony dated February 27, 2003, on pp. 13-16 and in SCPIE Exhibit 15, pp. 0218-0227. WT Mr. Schwartz, March 9, 2003, p. 35. Mr. Schwartz details the underlying data and assumptions for his cost of capital analysis in his amended written direct testimony dated March 9, 2003 on pages 34-40 and in Foundation Exhibit 111, pp. 0033-0041.

⁷⁵ RT Volume II, p. 125.

growth rate are required. The sum of these two quantities is the cost of capital. Dr. Appel relied on the estimate for the expected first year dividend yields provided in the Value Line Investment Survey (“Value Line”), a noted and reliable source for this data.⁷⁶ He estimated the dividend growth rate using several data sources, including historical earnings and dividend growth, analysts’ forecasts of earnings and dividend growth and a method known as “fundamental” or “sustainable growth” analysis. Dr Appel again relied on data provided by Value Line for the historical growth figures and forecasted growth rates. In general, he gave equal weight to the historical and forecast values in determining the projected dividend growth. After he calculated the cost of capital for the full sample of 25 property/casualty insurers covered by Value Line, the results of these analyses show a DCF cost of capital average of 10.25%.⁷⁷ Mr. Schwartz’s DCF analysis produced an average cost of capital equal to 10.2%, a similar result.⁷⁸

According to Dr. Appel, the CAP Model looks at data going farther back in history than the data used by the DCF model and, to some extent, may give that data more weight.⁷⁹ The CAPM begins with the assumption that there is a risk-free asset, which is typically a U.S. Treasury security. The model then estimates the relative risk of alternative securities in order to measure the “risk premium” investors require to hold the “risky asset.” The relative risk of a particular security is measured by a value known as “beta” which is an estimate of the relative volatility of that security’s returns compared with the volatility of the entire market, usually

⁷⁶ According to Dr. Appel, Value Line Investment Survey is an independent investment advisor service that provides weekly reports on approximately 1,700 publicly traded stocks. In addition, it provides in depth quarterly reports on each of the firms it covers, which contain detailed historical and forecast information on each security. Value Line is the largest such service in the world and is the data source most widely relied upon by experts estimating the cost of capital in regulatory proceedings. The data Dr. Appel used came from Value Line’s “Insurance-Property/Casualty” group of companies. WT Dr. Appel, January 29, 2003, p. 29.

⁷⁷ WT Dr. Appel, January 29, 2003, pp. 17-18, 31.

⁷⁸ WT Mr. Schwartz, March 9, 2003, p. 35.

“proxied” by the New York Stock Exchange index or the S&P 500.⁸⁰ To implement the CAPM, estimates of the current risk-free rate, the beta of the individual stock and the market risk premium are required.⁸¹

Dr. Appel obtained the risk free rate based upon the most recent three months of data on short, intermediate and long-term yields for 3-month US Treasury Bills, 5-year U.S. Treasury Notes and 20-year U.S. Treasury Bonds, as provided by the Federal Reserve Board. Dr. Appel chose to average the yields on these securities for the 3-month period from July through September 2002 to provide a representative estimate of current interest rates without any anomalous results that might arise due to unusual interest rate volatility. During this period, the yields on 3-month Treasury Bills averaged 1.69%, the yields on 5-year Treasury Notes and 20-year Treasury bonds averaged 3.35% and 5.19% respectively.⁸² Mr. Schwartz, following the CAPM analysis, used a 3-month time period from November 2002 to January 2003 to analyze the data that produced lower averages for these treasuries.⁸³ The approaches used by Dr. Appel and Mr. Schwartz appear reasonable for a rate that was initially to be effective on January 1, 2003.

For the market risk premium, Dr. Appel obtained estimated betas on a representative sample of 25 property/casualty insurers from Value Line. The beta coefficient for this sample of companies ranges from 0.75 to 1.45, and averages 0.97. Mr. Schwartz used a beta of 0.86 based on more recent data and 46 instead of 25 companies.⁸⁴ The use of more recent data and a larger

⁷⁹ RT. Volume II, p. 125.

⁸⁰ WT Dr. Appel, January. 29, 2003, p. 32.

⁸¹ WT Dr. Appel, January. 29, 2003, p. 17.

⁸² WT Dr. Appel, January 29, 2003, p. 32.

⁸³ WT Mr. Schwartz, March 9, 2003, p. 37.

⁸⁴ WT Mr. Schwartz, March 9, 2003, p. 39.

group may result in a more accurate estimate of betas but both approaches are ultimately sound since the group of 25 is large enough to provide a credible distribution.

Dr. Appel relied upon the arithmetic mean risk premium provided in “Stocks, Bonds, Bills and Inflation” (2002 edition) by Ibbotson and Associates for his market risk analysis. He estimated the market risk premium by relying on the entire data set developed by Ibbotson that begins in 1926 and continues through 2001. The results of this calculation produced market risk premiums of 8.80% for the short term, 7.50% for the intermediate term and 7.40% for the long term.⁸⁵ Mr. Schwartz calculated the market risk premium by using a subset of the data developed by Ibbotson that spans a period from 1960 through 2000. His calculations produced market risk premiums of 6.2% for the short term, 5.3% for the intermediate term and 5.0% for the long term.⁸⁶ Mr. Schwartz contends that calculating the market risk premium by using the entire data set inflates the results. Dr. Appel counters that Mr. Schwartz relies on a downward biased estimate of the market risk premiums since the 1960 - 2000 data subset he chose produces the lowest estimate of the risk premium possible given the available data. While Mr. Schwartz cites to a text that suggests using a smaller data subset is appropriate, Dr. Appel cites to an article by Professor Ibbotson that states all periods contain unusual events and the period 1926 to 2001 is representative of what can happen and should be used in its entirety.⁸⁷ The ALJ finds that using the entire period from 1926 to 2001 is a sound approach for predicting future market risks because all eras have unusual events and the use of the entire data-base fairly represents what can happen without unduly emphasizing one period over another.

⁸⁵ SCPIE Exhibit 15, p. 0226.

⁸⁶ WT Mr. Schwartz, March 9, 2003, p. 37.

⁸⁷ WT Dr. Appel, February 27, 2003, pp. 13-16; WT Mr. Schwartz, March 9, 2003, p. 37.

Combining the information concerning the recent yields on U.S Treasury securities, beta coefficients for the property/casualty insurance industry and the historical differential between risk-free and equity investments, Dr. Appel estimated the cost of capital to be 11.15%. Weighing the DCF and CAPM approaches equally Dr. Appel selected a cost of capital of 10.70% as his best estimate of the required return for the average risk of property casualty insurance. Dr. Appel noted that because traditional estimates of beta fail to account for interest rate risk, the CAPM estimates of the cost of capital is understated and he therefore believes the overall 10.70% cost of capital represents “the lower bound for the cost of capital for the entire industry.”⁸⁸

In addition to using the DCF and CAPM approaches, Mr. Schwartz completed a cost of debt analysis and determined the proportion of capital from equity and included these results to obtain an overall cost of capital in the amount of 8.3%.⁸⁹ These additional approaches afford a more sophisticated analysis but the ALJ also finds Dr. Appel’s approach actuarially sound. Though SCPIE’s estimated cost of capital is higher than the Foundation’s, the ALJ finds that the 10.7% rate of return is a reasonable reflection of the maximum rate of return for the 2003 rate period. The maximum profit factor, then, is 10.7.

IV. CONCLUSION

The regulatory formula provides for the calculation of a maximum permitted earned premium and a minimum permitted earned premium. An insurer is allowed a rate increase that will bring in the maximum permitted earned premium or any amount between that and the

⁸⁸ WT Dr. Appel, January 29, 2003, pp. 16-18, 33. However, his cost of capital analysis for January 2003, which is not yet complete, indicates that the DCF results based on January 2003 data have declined 15 basis points due to a decline in the risk-free rate alone. Dr. Appel estimates that the market risk premium will decline by 30 to 40 basis points, meaning that the CAPM estimates will probably fall by around 50-60 basis points once the final data is

minimum earned premium, but not a larger increase. A larger increase would provide profits that were excessive in relation to the insurance provided.

In the instant case, SCPIE has not carried its burden of proof that its requested rate increase would yield an earned premium within the range of reasonableness as defined by the regulatory formula. However, it has shown that a rate application in conformity to Appendix 1 of this proposed decision, indicating a rate increase of 9.9 percent, would yield an earned premium that is not excessive or inadequate.

V. FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. All findings in this decision shall be considered to be either findings of fact or conclusions of law. They should be read in conjunction with the discussion above which explains the reasons for the determinations.
2. The hearing was full, fair and allowed the parties a reasonable opportunity to present relevant evidence and argument.
3. SCPIE bears the burden of proving that its requested rate increase will not result in excessive, inadequate or unfairly discriminatory rates as defined in CCR §2644.1 *et seq.*
4. In a rate hearing, the Commissioner reviews SCPIE's proposed rates and determine whether they are excessive, inadequate or unfairly discriminatory using the methodology set forth in CCR §§2642.1 *et seq.*
5. There is no dispute with regard to the following factors calculated using the formulas set out in the regulations: Projected Fixed Expenses (0.9967); Projected

collected. Based on the foregoing, Dr. Appel believes the January 2003 cost of capital will average 10.35%. WT Dr. Appel, January 29, 2003, pp. 19-20.

⁸⁹ WT Mr. Schwartz, March 9, pp. 37-40.

Ancillary Income (4.7); Variable Expense Factor (4.3%); Investment Income Factor (18.9%); Projected Yield (5.6%); Reserve Ratio (3.375).

6. SCPIE's separate development and trending of its DD&R losses and ALAE is not permitted under CCR §2644.4. SCPIE's DD&R losses and ALAE shall be included in SCPIE's historical losses and ALAE and developed and trended in the aggregate.

7. SCPIE's projected losses and ALAE that are developed and trended and that are depicted on SCPIE Exhibit 51, (lines 5-12) p. 0507 attached as Appendix 1 to this proposed decision are reasonable.

8. SCPIE's maximum profit factor based on a 15% rate of return is not supported by the evidence in the record.

9. Based on the record, a maximum profit factor of 10.7% based on a rate of return of 10.7% is reasonable.

10. Based on the record, a rate increase of 9.9% as reflected in line 25 of SCPIE Exhibit 51, p. 0507 using the values for projected losses and ALAE from Exhibit 51, p. 0507 and all other agreed upon values indicated in Exhibit 51, p. 0507 is reasonable.

ORDER

Based on the foregoing, IT IS ORDERED that:

1. the requested rate increase of 15.6% is rejected.
2. a 9.9% rate increase is approved and shall become effective 20 days after the adoption of this decision by the Commissioner or as soon thereafter as SCPIE is able to provide the necessary documentation to and implement the necessary changes with the California Department of Insurance Rate Filing Bureau.

This proposed decision is submitted on the basis of the entire record in this proceeding and I recommend its adoption as the decision of the Insurance Commissioner of the State of California.

DATED: July 24, 2003

/s/
MARJORIE A. RASMUSSEN
Administrative Law Judge